R5650-2

JAPAN · ECONOMIC · INSTITUTE

# JEI REPORT

A Two-Part Report: A and B

NO. 7B
February 16, 1990

IN THIS ISSUE:

Current Account Drops Sharply In 1989 ..... 1

Japan's Financial Reform Schedule ..... 4

Japan Is On Course
For Strengthening Antimonopoly Law ..... 6

Japan Reacts To U.S. Defense Cuts Proposal ..... 8

Hills Tells Capitol Hill
Of Trade Negotiation Progress ..... 9

Japan-Taiwan Update ..... 11

Notes: Socialist Tax Reform Plan ..... 12

## Current Account Drops Sharply In 1989

Officially, Tokyo and Washington agree on at least one important economic policy objective: Japan's huge balance of payments surplus should come down. But for years achieving such a goal has seemed like a search for the proverbial light at the end of the tunnel: real progress remained just around the next bend. Even when the broadest-based measure, the current account, declined -- as it did in 1988 -- economists ordered the celebrations canceled after deciding the light was a mirage, caused by some or another quirk in the data.

Toward the end of 1989, however, the figures began to shine a little more brightly. In the October-December period the current account deficit dropped a whopping 50.5 percent compared to the same period in 1988. The year-to-year comparison was distorted by an unusually large surplus a year earlier, but the 1989 figure was still impressive, being lower than any fourth quarter result since 1984.

For the year, Japan's dollar-denominated current account deficit declined 28.5 percent compared to 1988 -- from $79.6 billion to $57 billion -- pushing the figure to a level close to $49.2 billion achieved in 1985 (see Table 1). In addition, the surplus as measured in yen reached the lowest level since 1983. Furthermore, more than one factor contributed to the improvement. For example, not only did imports surge 16.8 percent, but exports rose a modest 3.8 percent. In addition, the final major component of the current account, services -- which include categories such as transportation, travel and investment income -- registered a deficit that was 41.4 percent larger than a year earlier. The increase in the services imbalance was largely a consequence of the deficit in tourism rising faster than the net surplus of investment income.

Table 1: Japan's Balance of Payments

(in millions of dollars, IMF value basis)

| | 1985 | 1986 | 1987 | 1988 | 1989* |
|---|---|---|---|---|---|
| Current Account | $49,169 | $85,845 | $87,015 | $79,631 | $56,975 |
| Trade Balance | 55,986 | 92,827 | 96,386 | 95,012 | 77,130 |
| Exports (f.o.b.) | 174,015 | 205,591 | 224,605 | 259,765 | 269,631 |
| Imports (f.o.b.) | 118,029 | 112,764 | 128,219 | 164,753 | 192,501 |
| Services | -5,165 | -4,932 | -5,702 | -11,263 | -15,925 |
| Transfers | -1,652 | -2,050 | -3,669 | -4,118 | -4,230 |
| Long-Term Capital | -64,542 | -131,461 | -136,532 | -130,930 | -87,928 |
| Basic Balance | -15,373 | -45,616 | -49,517 | -51,299 | -30,953 |
| Short-Term Capital | -936 | -1,609 | 23,865 | 19,521 | 20,825 |
| Errors and Omissions | 3,991 | 2,458 | -3,893 | 2,796 | -23,158 |
| Overall Balance | -12,318 | -44,767 | -29,545 | -28,982 | -33,286 |

*Preliminary.

Source: Bank of Japan

Table 1 illustrates an important principal of the balance of payments: to the extent that the current account declines, as it did in 1989, international financial flows change as well. The current account surplus is partly offset by outbound long-term capital movements; the basic balance indicates the amount left to be covered by short-term private and official flows, partially represented in the table by short-term capital and errors and omissions. In recent years, the outbound long-term capital flows have been more than sufficient to cover the current account surplus, implying that the remaining figures showed a net inflow.

Table 2 gives some details of the long-term capital account. Note that it is dominated by two figures: an outbound flow of "ordinary bonds," which represent Japanese purchases of U.S. Treasury and other bonds on foreign securities markets, and an inbound flow of "external bonds," which are foreign purchases of bonds issued by Japanese firms on Euromarkets and elsewhere. While full-year data are not available, figures for the first half of 1989 suggest that the outflow is heavily toward the United States. The inflow comes overwhelmingly from Great Britain, a center of Euromarket activity.

Table 2: Net Long-Term Capital Flows

(in millions of dollars)

| | 1988 | | | 1989* | | |
|---|---|---|---|---|---|---|
| | Outflows | Inflows | Net | Outflows | Inflows | Net |
| Direct Investment | $-34,210 | $-485 | $-34,695 | $-43,786 | $-1,080 | $-44,866 |
| Trade Credits | -6,939 | -18 | -6,957 | -3,690 | -7 | -3,697 |
| Loans | -15,211 | -82 | -15,293 | -22,457 | 17,813 | -4,644 |
| Securities | -86,949 | 20,298 | -66,651 | -113,285 | 85,144 | -28,141 |
| Stocks | -2,993 | 6,810 | 3,817 | -17,887 | 6,998 | -10,889 |
| Bonds | -85,812 | -21,628 | -107,440 | -94,083 | 2,400 | -91,683 |
| Yen-Denominated Bonds Issued in Japan | 1,856 | n.a. | 1,856 | -1,315 | n.a. | -1,315 |
| External Bonds** | n.a. | 35,116 | 35,116 | n.a. | 75,746 | 75,746 |
| Other | -6,574 | -760 | -7,334 | -7,558 | 978 | -6,580 |
| Total | -149,883 | 18,953 | -130,930 | -190,776 | 102,848 | -87,928 |

Note: A negative sign indicates a capital outflow.

*Preliminary.
**Bonds issued outside of Japan by Japanese institutions.

Source: Bank of Japan

Wall Street gets jittery whenever it thinks that Japanese purchases of U.S. securities might slow, believing that Japanese investors are needed to keep pumping money into American markets to keep U.S. interest rates from soaring. This argument suggests that Wall Street -- absent changes in U.S. savings and investment behavior -- tends to prefer a large Japanese current account surplus to a smaller one.

In 1989, however, the decline in the current account -- and long-term net capital outflows -- was not accompanied by a decline in Japanese purchases of foreign long-term securities. In fact Japanese investors significantly increased their purchases of "ordinary bonds" such as U.S. Treasury bonds. Instead, the inflow of external bonds increased.

In short, the figures demonstrate the extent to which Japanese financial markets are internationalizing. While the need to recycle Japan's current account surplus may have helped spur Japanese interest in overseas financial markets, the 1989 data suggest that a decline in that surplus will not necessarily reverse the trend. As Japanese institutions increasingly raise money abroad, continued large outbound capital flows could well be consistent with a declining balance of payments surplus. This development suggests that, should the current account outlook continue to brighten, the result need not force destructive fireworks on Wall Street.

Douglas Ostrom

Japan-Taiwan Update

Japan's economic links with Taiwan are a striking contrast to the strains that have prevailed with Beijing over the Chinese government's June 1989 suppression of prodemocracy student demonstrators. Japan-Taiwan economic ties have prospered and are deepening thanks to financial market reforms in both countries. The changes have shifted Japanese corporate attitudes toward Taiwan from that of a low-wage production base to a rapidly growing consumer and financial market.

In response to the yen's 1986-1988 rise against the dollar, Japanese corporations moved production facilities to Asian nations with lower labor costs, including Taiwan. The annual amount of direct investment in Taiwan by Japan rose rapidly from $65 million in FY 1984 to $115 million in FY 1985, $291 million in FY 1986 and $367 million the following year. In FY 1988, however, investment growth was modest as Japan added $372 million for a cumulative total of just under $1.8 billion invested as of March 31, 1989. Although exact data are not available, Japanese investment probably focused on areas of Taiwanese manufacturing strength: household appliances, electronic components (particularly computer-related), and light manufactures.

In 1988 the Taiwanese government began lifting controls on financial transactions, as Japan had done eight years earlier. Like Japan, Taiwan had developed an export-led economy in response to its relatively poor resource endowment. Also like Japan, Taiwan began to enjoy significant trade and current account surpluses, generating a large pool of funds for investment and consumption. If investment opportunities in Japan are considered limited by U.S. or European standards, so much more so have been the options in Taiwan because of its underdeveloped financial system and stringent controls on foreign exchange and overseas investment. Faced with a growing surplus of savings, the Taiwanese government began to ease controls and encourage the financial system to develop. Taipei's actions also were driven by the understanding that the country was rapidly losing its wage advantage and would have to compete through improving the value-added component of its manufactures.

Attracting foreign investment is a key part of this upward shift, mandating that financial controls be eased. Banking laws are being brought into line with the norms of Western advanced industrial nations; the stock market is being modernized and opened to foreigners; controls on outward and inward direct investment are being eased. Paralleling these changes in financial markets, Taipei is easing its grip on the flow of imports, encouraging purchases of both consumer and industrial goods. The Taiwanese quickly have moved to take advantage of this, freely buying what once were considered luxury goods from overseas.

Faced with growing frictions with the United States and uncertainty about the impact of the European Community's plan to become more fully integrated in 1992, Japanese corporations have turned greater attention to Asian neighbors. Japan's Big Four securities firms -- Nomura Securities Co., Ltd., Daiwa Securities Co., Ltd., Yamaichi Securities Co., Ltd. and Nikko Securities Co., Ltd. -- either have bought or are planning to buy a stake in Taiwanese brokerage houses. They have created mutual funds based on Taiwanese stock for Japanese investors and are exploring underwriting both government and private debt in Taiwan. Japanese banks and brokers also are willing to help Taiwanese

companies expand abroad or engage in mergers and acquisitions at home. Japanese manufacturers, too, are trying to position themselves to catch the growing wave of consumer spending in Taiwan. Nissan Motor Co., Ltd., for example, is considering shipping cars and trucks from its production plants in the United States and Europe to Taiwan to meet the strong demand for foreign vehicles. Although both Nissan and Toyota Motor Corp. have stakes in local Taiwanese carbuilders, local production focuses on subcompact and commercial vehicles, not larger, more luxurious cars. Taiwan's homegrown electronics and computer industry is attracting Japanese research and production investments. Japanese department stores and consumer electronics firms hope to cater to both middle class and upscale shoppers.

In contrast to Japan's relations with China, which have been strained and highly visible, links to Taiwan have been quietly expanding. Given that Japanese businessmen see a "Pacific" century coming, it is not surprising that ties to one of the most vital and advanced of the newly industrialized Asian economies -- Taiwan -- have grown and are likely to continue to do so.

Jon Choy

Japan's Trade with Taiwan, 1985-1989

| | Exports | | Imports | | Balance | |
|---|---|---|---|---|---|---|
| | Value | Change | Value | Change | Value | Change |
| | a. in millions of yen | | | | | |
| 1985 | Y1,204,790 | -15.0% | Y810,867 | 7.0% | Y393,923 | -40.3% |
| 1986 | 1,312,442 | 8.9 | 786,934 | -3.0 | 525,508 | 33.4 |
| 1987 | 1,644,839 | 25.3 | 1,034,145 | 31.4 | 610,694 | 16.2 |
| 1988 | 1,838,998 | 11.8 | 1,119,953 | 8.3 | 719,045 | 17.7 |
| 1989 | 2,122,811 | 15.4 | 1,229,200 | 9.8 | 893,611 | 24.3 |
| | b. in thousands of dollars | | | | | |
| 1985 | $5,025,462 | -16.0% | $3,385,531 | 5.7% | $1,639,931 | -41.0% |
| 1986 | 7,851,703 | 56.2 | 4,609,521 | 36.2 | 3,242,182 | 97.7 |
| 1987 | 11,346,272 | 44.5 | 7,128,062 | 54.6 | 4,218,210 | 30.1 |
| 1988 | 14,354,380 | 26.5 | 8,743,451 | 22.7 | 5,610,929 | 33.0 |
| 1989 | 15,424,722 | 7.5 | 8,965,473 | 2.5 | 6,459,249 | 15.1 |

Source: Ministry of Finance

Notes

Socialist Tax Reform Plan - The chairwoman of the Japan Socialist Party, Takako Doi, acknowledged February 4 that the opposition parties' final tax reform plan includes a variety of small-scale indirect taxes, such as commodity and excise taxes, a tax on admission to theaters or stadiums and a tax on electricity bills. These taxes were repealed last April at the introduction of a 3 percent consumption tax. Ms. Doi, who is campaigning for lower house elections, made this announcement to clarify the noncommunist oppositions' tax reform